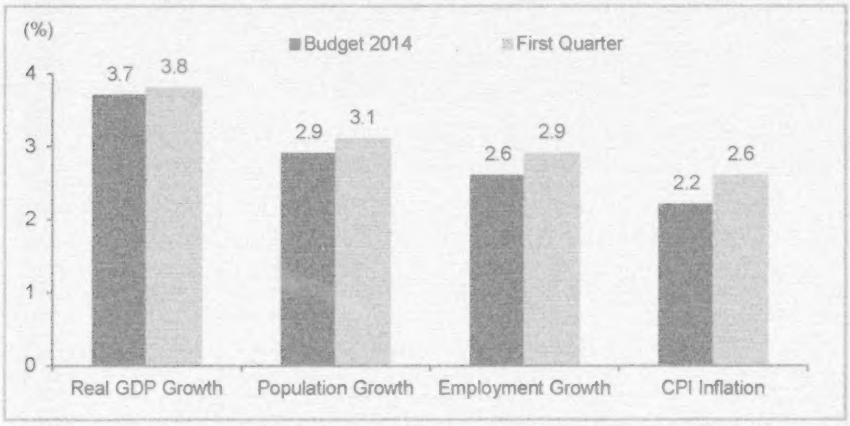
Economic Trends

Strength across the board

This edition of Trends is taken from the First Quarter Fiscal Update and Economic Statement, released on August 27th, 2014. The inFocus compares cost pressures in the current economic expansion with the 2004-2008 boom period.

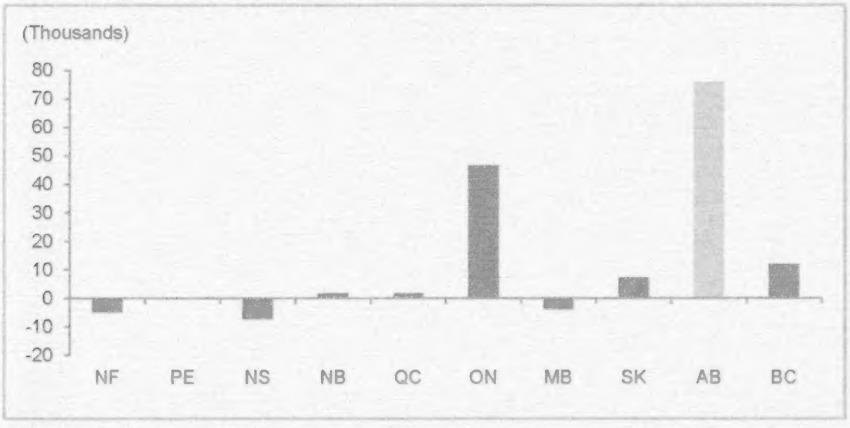
Alberta's economy is powering ahead after a strong 2013. The labour market continues to buck the national trend, leading all provinces in job growth this year and attracting large inflows of migrants to Alberta. This is putting pressure on the housing market, where starts have been trending higher. Business activity has picked up in the first half of 2014, with manufacturing shipments and exports accelerating.

Chart 1: 2014 Alberta economy in full expansion
Forecast for Key Alberta Indicators



Source: Statistics Canada and Treasury Board and Finance

Chart 2: Alberta leads all provinces in employment growth
Year-to-date Employment Growth by Province*



Source: Statistics Canada
* January to July 2014 vs. January to July 2013

Higher natural gas prices have led to a rebound in rig activity.

Based on recent headway, economic growth in 2014 and 2015 is forecast to be slightly higher than the strong outlook at *Budget 2014*. Real GDP is now expected to grow 3.8% in 2014 (Chart 1) and 3.1% in 2015. This reflects a stronger than expected labour market, continued migration into the province, and accelerated activity in the business sector. While costs have been contained so far (see pg. 3-4), inflation has picked up in the province and nationally.

Alberta Household Sector

Persistent labour market growth
Alberta has been Canada's job engine, leading all provinces in job gains over the first half of 2014 (Chart 2). While employment growth has surged year-to-date, it is expected to stabilize over the remainder of 2014. Employment is now forecast to grow by 2.9% in 2014, up from the *Budget 2014* forecast of 2.6%. The labour force is keeping pace with employment gains, thanks to in-migration. The unemployment rate is now expected to average 4.6%, up slightly from 4.4% at *Budget 2014*, due to strong entry into the labour force.

Population forecast revised higher
Lured by better job prospects, Alberta remains a destination of choice for migrants. After a record-setting year in 2013, interprovincial migration has remained strong, and international migration is expected to be at record levels in 2014. From July 2013 to April 2014, the province gained around 62,400 people from other provinces and countries. As a result, the population is forecast to grow by 3.1% in 2014, up from 2.9% at *Budget 2014*. In 2015, population growth is expected to be 2.8%.

Housing market tightens
Alberta's residential market has surged, driven by strong gains in

income and population. The rental market remains tight, with vacancy rates in the major urban centres extremely low. Housing starts are up a solid 8.9% over the first seven months of 2014. Activity is particularly strong in Calgary, where housing starts spiked in June in the face of historically low inventories and rising prices for new homes. Investment in multi-unit construction has been the main contributor to growth so far this year.

The strength in residential investment was largely expected at *Budget 2014*. The forecast for housing starts has been adjusted up slightly, to 38,800 units in 2014 and 37,100 in 2015, reflecting higher year-to-date numbers.

Inflation picks up

Inflation has climbed in Alberta, due in large part to a spike in energy prices earlier in the year and increasing prices for food and accommodation. Rents and owned accommodation, including insurance and property taxes, are expected to add more to inflation in 2014 than in recent years. The forecast for consumer price inflation has increased for this year, from 2.2% at *Budget 2014* to 2.6%. For 2015, consumer prices are forecast to grow by 2.5%, up from 2.1% at *Budget 2014*.

Alberta Business Sector

Business activity remains robust

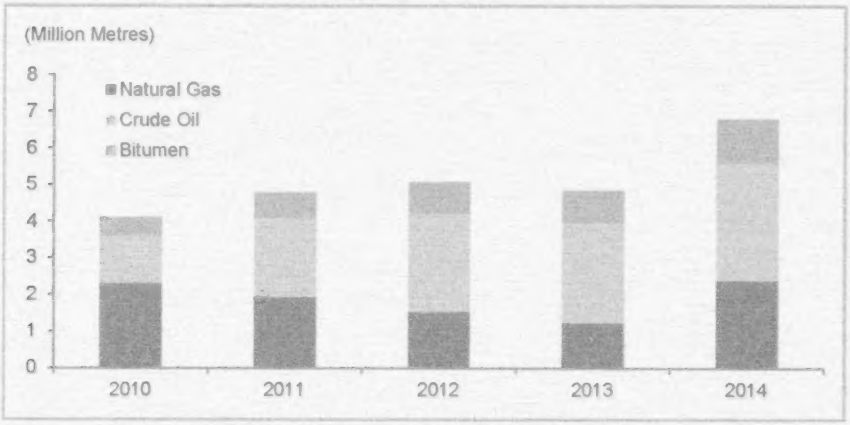
Alberta's business sector continues to see vibrant growth, with manufacturing shipments, exports, and production of crude oil products accelerating so far in 2014.

Exports and shipments are benefitting from strong oil prices, which have been tracking higher than forecast in *Budget 2014*. Despite lagging demand in the Atlantic basin and elevated global inventories, oil prices have been supported by global geopolitical turmoil. Heavy crude prices in Alberta have strengthened on strong demand and increased rail shipments, which have helped alleviate local pipeline bottlenecks. Exports, particularly for oil and manufacturing products, are forecast to be slightly stronger in 2014 and 2015, compared with *Budget 2014*. Imports have also been adjusted up due to strong consumer and business demand.

Conventional energy investment increases

Natural gas prices have strengthened in the first half of 2014, boosted by a particularly cold winter and historically low inventory levels. As a result, drilling activity has picked up considerably (Chart 3). The increase in natural gas spending has led to a slight upward revision of the forecast for mining and oil and gas investment in 2014. The 2015 estimate remains unchanged.

Chart 3: Natural gas activity jumps
Total Metres Drilled in Alberta - January to May



Source: Alberta Energy Regulator

Overall investment in non-residential construction in the province is on track with the *Budget 2014* forecast. Commercial and institutional spending is up, which has more than offset a pullback in industrial spending.

Canadian dollar forecast adjusted up

The Canadian dollar has appreciated since early 2014. This is in part due to a shift in expectations about interest rates, as Canadian inflation has been higher than expected. The exchange rate forecast for 2014/15 has been increased, from 91 US¢/Cdn$ at *Budget 2014* to 92.5 US¢/Cdn$.

External Risks

Global economic conditions are slowly improving, but with mixed results. The US economy is gaining momentum, while Eurozone growth has stalled and China has entered a period of slower growth. Given Alberta's high reliance on trade and commodities, the outlook is subject to a number of risks:

- A lack of spare pipeline capacity makes the price of oil produced in Alberta vulnerable to transportation and refinery disruptions.
- Financial markets have seen strong returns in the past couple of years. A market correction could drag down commodity prices and hamper global growth. Escalating geopolitical events, such as tensions in Ukraine or Iraq, could also dampen global economic growth and increase financial market volatility.
- A pick-up in global inflationary pressures could lift consumer prices more than forecast, while weaker-than-expected migration could put upward pressure on labour costs.
- There is upside risk for Alberta's outlook if employment, business investment, and housing maintain current momentum.

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inFocus

Cost escalation then and now

In 2012 and 2013, Alberta real GDP grew at an average annual rate of 3.9%. This is identical to average growth during 2004 to 2008. The major difference between now and then is that cost inflation was much higher in the earlier period, when demand for Alberta goods and services was greater than the economy's capacity to produce them, leading to rapid cost escalation.

This special feature looks at why costs have been contained this time around and whether this is likely to continue.

Key factors

- Inflation in 2004-2008 was driven by a near doubling of house prices, which pushed up shelter costs.
- Weak economic activity outside Alberta kept inflation low in 2012 and 2013.
- With fewer opportunities outside Alberta, migrants have been flooding in, curbing wage growth.

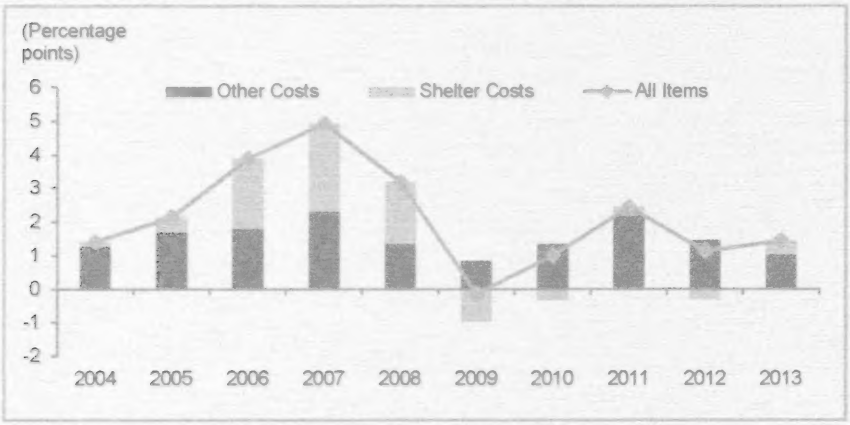
Consumer prices

In 2013, consumer prices in Alberta increased by 1.4%. This compares with 4.9% in 2007 at the height of the boom. There are two primary reasons for this difference. The first is shelter costs, which rose dramatically between 2005 and 2007, as rocketing home prices pushed up costs for homeowners and increased rents. The second is the national inflation rate, which has been much weaker than is typical.

Home prices drive inflation

The Alberta housing market started to heat up in 2005 and reached its pinnacle in 2007. Over the two years ending in July 2007, both the New Housing Price Index and the average price of existing homes increased by around 75%. This caused shelter costs to rise for home buyers in particular, but also for renters. The owned accommodation component of the Consumer Price Index (CPI) increased by 15% in each of 2006 and 2007, by far the largest contributor to inflation in both years.

Chart 1. Shelter costs drove inflation during the boom
Contribution to Alberta consumer price inflation



Source: Statistics Canada and Treasury Board and Finance

Excluding shelter costs, inflation in Alberta was only slightly more elevated than inflation nationally over this period.

Of the 3.4 percentage point difference between the inflation rate in 2007 and 2013, shelter costs account for well over half (Figure 1). Home prices during the post-recession expansion have grown at a much more sustainable rate. Though prices in Calgary have started to gain momentum, the growth rate is not substantially out of line with what prevailed before the boom.

Higher inflation mostly came through shelter because these costs are more responsive to local pressures. Most of the other components of the CPI basket are goods, which can be transported between regions to take advantage of local price differences. These prices are therefore more responsive to national and global conditions.

Weak activity outside Alberta

Part of the reason why inflation in Alberta was lower in 2013 than in 2007 is that inflation in Canada was lower. The national inflation rate was 2.1% in 2007, compared with just 0.9% in 2013.

Inflation has been low, in part, because of weak global demand, which has kept commodity prices in check. The BCPI, the Bank of Canada's trade-weighted commodity price index, grew by just 0.2% in 2013 after falling by 6.1% in 2012. This compares with a 6.7% increase in 2007 and an average annual increase of 16% over the 2004 to 2008 period.

While global price fluctuations can have transitory effects on Canadian dollar prices, underlying inflation is driven mostly by economic conditions in Canada. Economic growth in Canada since 2012 has been disappointing, averaging less than 2%. Labour market indicators point to further weakness, with the unemployment rate stubbornly staying around 7% and the employment rate near its recessionary low.

Construction costs

The construction industry's two largest inputs are labour and materials. Growth in both labour and materials costs has been much less pronounced during the current expansion. Labour costs have been contained of late by record levels of in-migration. Weaker job markets in other regions have increased the incentive to move to Alberta for work. Lower natural gas activity in the province, compared with the previous cycle, has also helped alleviate pressures on the labour market. Globally, weak demand has prevented commodity prices from rising, unlike 2004-2008, when commodity prices soared.

In-migration contains wage growth

In the last two years, the number of people coming to Alberta has exceeded those leaving by almost 175,000, the highest two-year net in-migration in history. The added supply of labour has tempered wage growth, and kept the unemployment rate from falling below 4%. While a lower unemployment rate is typically a good thing, if it is too low, wage growth accelerates, thereby increasing labour costs for businesses. These costs are often recouped through higher prices. This is exactly what happened in 2007 and 2008.

Over the 2004 to 2008 period, real output in the Alberta construction industry grew by almost 60%, fueled by development in the oil sands. This rapid build up in construction drew resources from the rest of the economy, bidding up wages and prices. With labour scarce, employers struggled to find qualified applicants, leading to mismatches and unfilled positions. Productivity declined; workers were paid more, but produced less per hour.

The combination of higher compensation and lower productivity during the boom period caused unit labour costs (the ratio of labour compensation to output) to rise at a far faster rate than either 2012 or 2013. Rising unit labour costs pushed up overall construction costs (Figure 2).

Alberta firms have learned from the 2004 to 2008 period and become more adept at managing costs. For example, modular construction allows more work to take place at assembly plants rather than on-site. This improves labour productivity by moving more construction into a controlled environment. It also saves on other costs, including transportation and accommodation for employees.

Chart 2. Lower labour costs ease construction cost escalation
Annual growth of select costs in Alberta

Source: Statistics Canada
* Average of Edmonton and Calgary

Material costs have been stable

The same increase in commodity prices that led to the boom in Alberta, also increased the cost of materials to builders. The three largest goods inputs into construction are primary metals, fabricated metals and non-metallic mineral products. The metals and minerals component of the BCPI was flat over 2012 and 2013, largely because of weak global demand. By contrast, over the 2004 to 2008 period the same component increased at an average annual rate of 20%.

Are cost pressures returning?

Weak global activity has kept a lid on prices in the past few years, but pressures are emerging. In Alberta, consumer price inflation is expected to be 2.6% in 2014 and 2.5% in 2015, up from 1.4% in 2013 (see pg. 12). Wage growth, on the other hand, is expected to be only slightly higher than in 2013. Wages could be even stronger than forecast if it becomes more difficult to attract new workers, due for example to improving conditions outside Alberta.

Even if costs do grow faster than expected, a repeat of 2004-2008 is unlikely. During that period, rapidly growing global energy demand and fears about oil supply caused a huge increase in energy prices and a surge of investment into Alberta's oil and gas sector. Such large price increases are not expected, as emerging market growth has slowed and technological advances have unlocked vast reserves of oil and gas. Moreover, Alberta oil sands producers have already invested large amounts of capital and are shifting more to the production phase of development, which is less labour-intensive.

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